

May 6, 2015

## KEY TAKEAWAYS

The strength of the U.S. dollar was a major force in the collapse of interest rates over the past nine months. A weaker dollar should lead rates higher.

Key Rates	Apr 30 2014	Mar 30 2015	Apr 30 2015
<b>Treasury Yields</b>			
2 Year	0.41	0.56	0.57
5 Year	1.67	1.37	1.43
10 Year	2.65	1.92	2.03
30 Year	3.46	2.54	2.74
<b>Credit Yields</b>			
BBB Industrial 10 Year	3.67	3.13	3.39
<b>Muni Yields</b>			
AAA Ten Year	2.72	1.98	2.10
<b>Mortgage Backed Securities</b>			
30 Year FNMA Current Coupon	3.37	2.65	2.78

## APRIL IN REVIEW

- April was a choppy month in fixed income markets.
- Treasury prices initially rallied and then sold off heading into the end of the month.
- BBB credit yields showed even greater volatility.
- Higher quality muni's and MBS tracked treasuries.

## Outlook

Spotting “bubbles” in asset prices is a time honored tradition among investment strategists. Recognizing significant price distortions can lead to huge payoffs when market pricing normalizes. Such returns, however, do not come without significant risks. Inflated asset prices are often rationalized by investors as the new standard for that segment of the market or explained away as being underpinned by new developments. Most bubbles continue to inflate long after the label is first applied, making it hard to profit from bubble spotting. To quote Bernard Baruch, “Markets can remain irrational longer than you can remain solvent.”

The strength in Treasury prices over the past year is highly correlated to strength in two assets that have been identified as being in “bubble” territory: the German Bund (as a proxy for European interest rates) and the U.S. dollar. The Bund, the benchmark 10-yr German government bond, effectively traded at a yield-to-maturity of 0.05% last month. Faced with such low rates at home, European investors have poured money into Treasuries, which yielded 1.8% more and offered a chance to play the appreciation of the dollar. The dollar has been surging since last July on the belief U.S. growth was far stronger than in the rest of the world, making the U.S. an even more attractive destination for foreign capital.

Recent data has suggested U.S. growth estimates have been too optimistic. This has put pressure on the dollar. The high inverse correlation between the rise in the dollar and the drop in rates is shown below. Without the support of a rising currency, U.S. rates have been coming under pressure. At the same time, the

**EXHIBIT 1: \$US/10-YEAR TREASURY CORRELATION**



Source: Bloomberg Financial, LP

Bund, which was recently called the “short of a lifetime” by bond guru Bill Gross, has also sold off. U.S. bond prices were pulled higher (and yields lower) by inflated prices for the dollar and foreign bonds. As these assets deflate, our yields will surely come under pressure.

## Strategy

April was a trying month for many bond investors. Interest rates rose, despite the release of weaker economic data. Weaker data is usually a bullish development under normal market conditions. We believe the negative move reflects two developments: dollar weakness and the looming end of easy monetary policy.

Foremost, recent dollar strength has been a major factor in attracting foreign capital, pushing our rates lower. The U.S. economy has been perceived as a stronger bet than the rest of the world. Comments by the Federal Reserve and recent economic releases suggest these growth estimates might be too optimistic, and the dollar therefore too strong. The dollar has weakened, as a result.

Secondly, the Federal Reserve remains focused on normalizing interest rates. The start of this process has been pushed off, with an initial move now likely in the fourth quarter of 2015 or early 2016. However, this time frame is now close enough and the probability high enough to cause market participants to react. At least a portion of the recent rate move reflects the risk of tighter monetary policy being priced into market levels.

We have been keeping duration relatively short in client portfolios. We do not plan to change this stance without a meaningful increase in rates or a marked slowdown in economic growth.

The current market cycle is well advanced. This could provide some support in the form of further FOMC intervention if economic growth begins to slow. However, we believe the Fed would need to see a significant deterioration of growth rates before returning to quantitative easing - the most effective tool still available to the FOMC. Corporate bonds and certain asset backed securities would be vulnerable under such a scenario. We continue to be conservative with exposures to these asset classes. Given the lower level of liquidity in the post-Dodd Frank markets, we do not want to wait until the last minute to reduce risk.

Municipal bonds remain a particularly attractive asset class, in our opinion. We are still finding tax free municipal bonds with higher nominal yields than comparably rated bonds of similar maturities in other segments of the bond market.

Taxable municipal bonds remain attractive on a relative yield basis, especially given the resilient credit strength associated with their taxing authority. Default rates for municipal bonds are lower than for corporate bonds with the same credit rating.

As always, please contact us should you have questions.

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